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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 59

MABEL G. REINECKE, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS,

Petitioner,

vs.

EUDORA HULL SPALDING,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF AND ARGUMENT FOR RESPONDENT.

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BRIEF AND ARGUMENT FOR RESPONDENT.

I.

STATEMENT OF THE CASE.

There were two counts in the declaration, one (R. 1-8) for income taxes overpaid by the plaintiff for the year 1917 in the sum of $36,123.93, and a second count (R. 8-15) for such taxes overpaid for the year 1918 in the

sum of $65,028.10. No point arises on the pleadings or on the amount of recovery, if the method used as the plaintiff's basis of calculation is correct. The matter in issue was and is solely one of ascertaining depletion. The contention of the Government is that the market value on March 1, 1913, is not the basis for ascertaining depletion. The contention of the respondent is that allowances for depletion are to be based on comparative market values of ore in the ground as between March 1, 1913 and the year of extraction, but such allowances cannot exceed the March 1, 1913 market value of the ore in the ground being accounted for nor can they exceed the market value of the ore being accounted in the year of extraction.

The case was tried before the District Court to a jury, and all the evidence (R. 45) offered preserved in a bill of exceptions (R. 20-157), containing oral testimony (R. 20-46) and Exhibits A to X (R. 46-151). At the close of all the evidence the defendant as well as the plaintiff moved for an instructed verdict (R. 43), neither party thereafter asking to go to the jury. The amount recoverable on plaintiff's theory was not in dispute (R. 43).

The court instructed the jury to find for plaintiff in the amount of $118,043.21, resulting on plaintiff's contention. The jury returned such a verdict (R. 18). Judgment was entered thereon (R. 19). An appeal was taken to the Circuit Court of Appeals for the Seventh Circuit, which court affirmed the judgment on January 2, 1921 (R. 159), in an opinion, *Reinecke* v. *Spalding*, 30 Fed. (2d) 369 (R. 159-163). To this latter judgment of the Circuit Court of Appeals this certiorari was granted.

II.

STATEMENT OF THE EVIDENCE.

The evidence briefly stated was the following:

The plaintiff offered her income tax returns for 1917 and 1918 (R. 21) Exhibits A and B (R. 47, 55), and then showed her receipts of royalties under certain leases quarterly during 1917 and 1918 (R. 22). It was admitted that the plaintiff made her original returns in good faith without any intention to defraud (R. 29). Leases of the iron ore properties in question were offered (R. 28), Exhibits C to I, both inclusive (R. 63, 75, 83, 92, 100, 108, 116). They covered different tracts of land in St. Louis County, Minnesota. Lease Exhibit C (R. 63), as an instance, covered six different tracts, for the term of forty-five years from January 1, 1905, for the first five tracts, and fifty years from such date for the sixth tract, for the purpose of taking out the merchantable iron ore (R. 65) upon a royalty reserved of twenty-five cents per ton upon such ore mined and shipped (R. 66), with a compulsory minimum of extraction of 600,000 tons per year for the first forty-five years, and for the remaining five years of 300,000 tons. The minimum was to be paid quarterly each year (R. 67), and any ore paid for beyond extraction was to be applied in a subsequent year or years to pay for any extraction beyond the minimum (R. 67). The lessee was to pay all taxes and assessments (R. 69). The plaintiff leased an undivided one-sixth of the premises (R. 69). The lease was terminable by the lessor upon thirty days' notice for a sixty days' default in paying royalties or in performing conditions (R. 71), and by the lessee upon thirty days' notice without cause shown (R. 70).

The other leases were for different tracts for yearly minima varying from 100,000 tons, 50,000 tons, 75,000 tons per year, and terms varying from fifty years from July 1, 1902, fifty years from January 1, 1903, fifty years from October 1, 1902, twenty-five years from October 1, 1903, the other provisions being constant (R. 63-124). At the beginning of 1917 fifteen years of the term had expired on some leases and on one lease only eleven years of the term were unexpired.

The next exhibits, K and L, were letters from the Commissioner's deputy, showing a refiguring by the Department of depletion in 1917 from that taken by the taxpayer and likewise that of 1918 (R. 128, 130). The unit ton value of depletion for both years on the ore extracted was stated to be 8.8 cents per ton (R. 128, 130, 136, 141). When these papers were offered it was objected, first, that the method used by the revenue agent had no tendency to show the method used by the Commissioner (R. 29). But the figures show the method of calculating the depletion and the reasons for the additional amount of tax exacted for both years. The second objection was that the method used by the Commissioner was entirely immaterial (R. 30). Later the objection was said to be that "if the Commissioner made a mistake in applying his own method, then I am objecting." (R. 31.)

The figuring of this unit depletion per ton was shown in the letter, Exhibit K (R. 128) of the Commissioner as follows:

> "Your method of deducting from gross income the entire amount received as royalty from iron mines as depletion is not approved by this office. The correct amount to be deducted for depletion, based upon the unit cost per ton of mineral reserves, as of March 1, 1913, as determined by the Valuation Engineers of this Department is shown as follows:

Ore reserve, March 1, 1913, according to the Minnesota Tax Commission, as shown on questionnaire of the Royal Mineral Association, ... tons.	191,417,150
Less: Advance royalty payment by lessees, prior to March 1, 1913, on ..... tons.....	3,034,258
Net tonnage as of March 1, 1913.....	188,382,892
Your interest, one-sixth, March 1, 1913 ..... tons	31,397,148.7
Total average extraction, 1913 to 1918, inclusive ..... tons.....	4,770,000
Maximum life of mine allowed ..... years	40
Interest rate allowed.....	6%
Royalty rate per ton.....$	0.25
Your capital sum returnable in 40 years .....$	7,849,287.18
Present worth of your interest, March 1, 1913 .....$	2,782,551.64
Unit cost per ton, March 1, 1913, basis for depletion .....$	0.0886243
Depletion in 1916, 1,096,015.4 tons at $0.0886243 .....$	97,133.60
Depletion in 1917, 1,040,289.4 tons at $0.0886243 .....$	92,194.92

The additional taxes in the amount as noted above will be assessed at an early date and notice as to place and time of payment will be sent you by the collector of internal revenue for your district.

Respectfully,

(Signed) G. V. NEWTON,

Acting Assistant to the Commissioner."

The depletion of 1916 is not in question here, but rather that of 1918, the calculation for which has a cross reference to the year 1917 as its justification for the figure .088 as the depletion unit per ton (R. 133).

In this figuring the net upaid for ore reserve of all lessors was taken as of March 1, 1913, at 188,382,892 tons and the taxpayer's interest of one-sixth was taken for the taxpayer at 31,397,148.7 tons. Then the total

average yearly extraction for the years 1913 to 1918, inclusive, was figured, so as to reach an average, using even the 1918 extraction, as to which the taxpayer, figuring for 1917, could have no prophetic knowledge. Roughly the average yearly extraction divided into the total net assumed ore reserves made the figure 40. Thereupon an average maximum life of the mines was fixed at forty years. This involved the assumption that from all the mines ore would be extracted for forty years and that the leases would last just forty years and no longer, nor for any lesser period. The capital sum returnable in forty years to this taxpayer was figured by multiplying the net tonnage of the taxpayer as of March 1, 1913, by twenty-five cents as royalty per ton, which gave $7,849,287.18 as this taxpayer's total return for the forty years assumed. The next figure given is the present worth of the taxpayer's interest under the lease on March 1, 1913. This is found by assuming that the net tonnage in the mines of March 1, 1913, will be taken out in forty equal annual extractions over forty successive years.

To this assumed forty equal extractions is applied the statement:

> "The value of the total royalties to be received during life of mines discounted of March 1, 1913, at six per cent and four per cent interest gives a unit value as of March 1, 1913, of $0.0886243 a ton." (R. 141 at bottom of page.)

The method is as follows: The one-sixth of the ore reserve of this taxpayer is treated separately. Each of the assumed forty equal annual extractions is divided into two parts. One part is assumed to go to the taxpayer as returns of the mine at six per centum per year on the present value to be ascertained. The other part is assumed to go into a sinking fund to draw interest at the rate of four per centum per year to the end of the

forty years. Interest is calculated on each of these sinking fund payments from the assumed yearly extractions at the rate of four per centum up to the end of the forty years from the year of payment. Those annual sinking fund parts of the assumed forty yearly equal extractions, with the interest calculated on each, are added together and the total is said to be the thus ascertained present value of the taxpayer's interest in the lease. This is admitted to be the Hoskold formula method in petitioner's brief, page 37. Then this assumed value of the mine so calculated is divided by the number of tons of the taxpayer in the net ore reserve on March 1, 1913, and the calculation gives eight and eight-tenths cents with a continued fraction, which is called the unit cost per ton on March 1, 1913, as the basis for depletion. Then that depletion unit of .088 is applied to the taxpayer's one-sixth of the tonnage extracted during the year 1917, and the result is said to be the taxpayer's depletion for the year 1917 (R. 128). The same unit is applied to 1918 (R. 141). Exhibit P corrected this calculation (R. 143) in a small amount which was arrived at as a total for all the leases by figuring equal extractions per year in each lease for the years of unexpired term, making the depletion unit a different one for the leases.

While the petitioner's brief, at page 4, states that "the record does not clearly show the method used by the Commissioner in computing the allowances," the brief in Appendix C, at page 38, states the method as taken from the Agreed Statement of Facts in *McHale* v. *Hull*, 16 Fed. (2d) 781, where precisely the same question was involved as follows:

> "The March 1, 1913, value of the net expected royalty income was determined by multiplying the net expected royalty income by a discount factor.

This discount factor was selected in accordance with the sinking fund method for valuing *equal annual amounts* of income. By this method the net expected royalty income (which said Commissioner *assumed* would be in equal annual amounts from March 1, 1913 to *the end of the unexpired term under* each indenture), pays simple interest of six per centum annually upon the March 1, 1913 value, *so determined,* and provides annually, in addition, a residuum of equal annual amounts which, if invested to accumulate at four per cent interest, compounded annually, would provide for the return of the March 1, 1913 *value* of *the net expected* royalty, *under each indenture,* at the expiration of the term of each indenture. The depletion rate per ton of ore for which royalty payment was received * * * was computed by the Commissioner, by dividing the * * * value of the net expected royalty income by the total estimated tonnage of ore in the mine subject to each indenture."

This is Hoskold's formula applied to each lease separately and assuming equal annual extractions during the years of the unexpired terms, thus resulting in a different unit of depletion for each lease.

Exhibits N and Q were the checks of plaintiff that paid the new assessments (R. 130, 140, 144). The remaining exhibits were claims for refunds and refusals thereof and Exhibits V, W and X were the calculations to show the reformed return with the resulting overpayment of tax with the amounts thereof and to show the amount of the quarterly payments, less interest therein contained from March 1, 1913, considering the payments as deferred from March 1, 1913, to the date of actual payment of royalties. The amounts that were principal in the payments were the amounts of money which, put at simple interest on March 1, 1913, at five per centum, would amount with that interest to the amount of the particular payment of royalty when made (R. 151). The

actuary showed the correctness of these calculations at five per centum interest (R. 36). These principal sums were the depletion from which interest was excluded. There is no contest over these latter calculations for plaintiff, if the method is correct.

The plaintiff proved by competent witnesses (R. 22, 27) the market value of each ton of iron ore extracted in 1917 and in 1918 and the market value of that ore on March 1, 1913, and for all the intervening period, to be at least twenty-five cents per ton (R. 23, 26, 27). The witnesses testified to the high merchantable character of the ore and the market value given was for the iron ore by the ton in the mine untouched and unextracted (R. 23) of all of the tonnage in place in the mine, whatever it might be, regardless of who owned it or what was the lease upon it (R. 25). One witness on cross-examination showed that what the Government's counsel was trying to get at was a method of figuring the plaintiff's (Mrs. Spalding's) interest in a lease, and not market value of ore (R. 24).

The defendant's only witness was first asked the method used in providing depletion out of income for amortization of bond issues (R. 37). Then the witness was asked to decide the legal question involved in the case (R. 38). Then the witness stated, under objection, that with reference to depletion "you take the tonnage as of March 1, 1913, and the value of the mine at that date, and you divide tonnage into value to get the value of a ton for depletion." (R. 40.) And then the witness said that his answer was based on no method stated as to fixing value of mine or tonnage. (R. 40, 41).

III.

THE STATUTES APPLICABLE FOR 1917 RETURN.

The general provisions of the statute for income tax returns of 1917 was the act of September 8, 1916, found at 39 Stat. L. 756, 758, Fed. Stat. Anno. Sup. 1918, p. 312, as follows:

> "Sec. 1 (a). That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income." (Other taxes were added upon this net income.)

The next general provision was as to what was included in income.

Fed. Stat. Anno Sup. 1918, p. 313, 314:

> "Sec. 2 (a). That subject only to such exemptions and deductions as are hereinafter allowed the net income of a taxable person shall include gains, profits, and income derived from * * * businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

(Sec. 2 (b) refers to estates of deceased persons and trustees and other fiduciaries.)

> "Sec. 2 (c). For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, 1913, the fair market price or value of such property as of March first, 1913, shall be the basis for determining the amount of such gain derived."

* * * * *

"Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be deducted as deductions—

First. (Necessary expenses)
Second. (Interest paid)
Third. (Taxes paid)
Fourth. (Losses incurred in business)
Fifth. (Losses incurred not in business)
Sixth. (Bad debts)
Seventh. (Depreciation of property)
Eighth. (a) (in the case of oil and gas wells)

(b) In the case of mines, a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the secretary of the treasury: Provided, that when the allowances authorized in (a) and (b) shall equal the capital originally invested or in case of purchase made prior to March first, 1913, the fair market value as of that date, no further allowance shall be made."

IV.

STATUTES APPLICABLE IN 1918 RETURNS.

The statute of February 24, 1919, for income tax returns of 1918, provides, 40 Stat. L. 1060, Fed. Stat. Anno. Sup. 1919, p. 92:

"Sec. 202 (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal or mixed, the basis shall be—

(1) In the case of property acquired before March, 1913, the fair market price or value of such property as of that date:

(2) (In the case of property acquired after that date).

It was provided in the same statute, 40 Stat. L. 1062, Fed. Stat. Anno. Sup. 1919, p. 94:

> "Sec. 210. That in lieu of the taxes imposed by subdivision (a) of section 1 of the Revenue Act of 1916 and section 1 of the Revenue Act of 1917, there shall be levied, collected and paid for each taxable year upon the net income of every individual a normal tax at the following rates:
>
> For the calendar year 1918, twelve per centum of the amount of the net income in excess of the credits provided in section 216." (Then followed other brackets.)

40 Stat. L. 1066, Fed. Stat. Anno. Sup. 1919, p. 99:

> "Section 214. Deductions allowed. (a) That in computing net income there shall be allowed as deductions (here followed nine different deductions).
>
> (10) In the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon costs, including cost of development not otherwise deducted: Provided, that in case of such properties acquired prior to March first, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * * In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

It will be seen that what is implied in the statute for 1917 is expressed in the statute for 1918, namely, that the provision as to depletion is a particular instance of a conversion of capital resulting in gain or income or loss.

V.

PROCEEDINGS IN CONGRESS ON ENACTMENT.

The intention of Congress in enacting the provision for depletion, so far as it is evidenced by the proceedings that we have found, is shown in the following record of the Senate:

The eighth deduction of the statute for 1917 was a senate amendment to the House Bill, and what was said is the only discussion, either in Senate or House, that appears to have been had on this provision.

When the amendment came before the Senate along with the other amendments to the House Bill reported by the Senate Committee, a discussion was had first as to the provision for oil wells and as to whether, under the provision as to oil wells, the taxpayer was compelled to pay a tax upon capital. Then the discussion passed to mines. Mr. Oliver, of Pennsylvania, stated that the producer should be allowed credit for the value in the ground. Mr. Williams, of Mississippi, in charge of the bill, stated very clearly that the intention of the bill was not to allow capital to be taxed under the guise of taxing income.

The discussion, so far as it is material, was as follows (53 Congressional Record, Senate p. 13285):

Mr. Williams (Miss.) stated in substance:

> The Committee does not think that this will result in taxing any part of the capital as income; that under the present law only 5 per cent of the gross value (income) was allowed to be deducted and that that was considered too little and a more equitable deduction was desired. (P. 13286, bottom of first column.)

Again he said (p. 13286, second column):

> "The rule that was fixed by the present law applied not only to oil wells and gas wells but to coal

mines and to metallic mines and to timber and to that entire class of industries with a self-consuming plant. It goes without saying that in all those cases a part of the product which is sold by the industry is a part of its capital. The desire was to tax the income part of what was sold and not to tax the capital part. We found that in connection with coal mines we could do that by fixing the value of the coal in the ground, but you cannot do that with oil or with gas. No living human being would know how to do it."

Then Mr. Williams proceeded to make an explanation that was incorrect, as to mines:

"Mr. Williams: If the Senator will notice the bill he will see that we have adopted a different rule for metallic mines and for coal mines, for the very reason that I have stated. The Senate committee undertook to try to fix a rule that would be just in each case. Of course, you can tell the value of the coal in the ground, because coal is coal; but you cannot tell the value of copper in the ground, nor the value of gold, nor the value of silver, because the ore when it comes out is neither gold nor silver nor copper; it is mixed with various other things. So we kept the old 5 per cent provision with regard to them, and then made a new rule as to gas and oil, and then we made a new rule as to coal, and then we changed the rule with regard to metallic mines by hedging it around so that the department could not, by ruling, do what it has done.

Mr. Chilton: Mr. President, I think the Senator will find he is mistaken in that statement. We tried to find a rule that would apply to all mines, and, hence, it was provided that they should have a deduction for all of the product mined and sold during the year, and I think the Senator is mistaken in saying that there was a different rule for metallic mines.

Mr. Thomas: The Senator said there was originally a different rule.

Mr. Chilton: Originally, but there is not now.

Mr. Williams: Oh, I remember now that in caucus that was changed upon the motion of some Senator, I think the Senator from Colorado made it, did he not?

Mr. Shafroth: It was done upon my motion.

Mr. Thomas: The value can be ascertained just as easily in one case as in the other. The method of procedure is different; that is all.

Mr. Phelan: Do I understand, then, that there is no rule, and that the department is to ascertain the value of copper and gold and silver buried in the ground in order to determine the amount of income tax?

Mr. Thomas: Mr. President, if the Senator will permit me to answer him, the only difference is one of process. The assay determines the metalliferous contents of metallic ore, while, of course, coal is a commodity, all of which in the vein is a commercial product. It is, therefore, merely a difference in the method of ascertaining the value. The output of a copper mine or of a lead mine for 12 months yields certain metalliferous contents, and the value in the mine of these contents is thus easily ascertainable. I will say to the Senator from California that the principle is one which occurs very commonly in his State and mine as a result of trespasses by one mine owner upon the property of another, sometimes willful and sometimes unintentional. Where it is unintentional the damages are based upon the value of the ore in the mine; and that is ascertainable, as I say, by assaying the contents and ascertaining them by chemical analysis. It is a perfectly simple and perfectly easy method of procedure.

Mr. Chilton: In the case of mines, it is 'a reasonable allowance for depletion thereof'—that is, for the depletion of the mine—'not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made.' Now, that is absolutely fair. No matter what it is, whether it is a coal mine or a copper mine or a silver mine. What we are trying to do is to ascertain the exact value of the depletion of the mine. What has been put upon the product in the way of labor or refining processes should not be estimated, but the value of what is taken out when in the mine; and that is perfectly fair, no matter what it may be, whether it is silver, gold, copper or coal.

Mr. Phelan: Would there be any income tax whatever if the whole deductions were made, the value of the whole product taken out of the mine for that year?

Mr. Chilton: Why, certainly, the profit on it. This refers to a deduction and it fixes that deduction at the value in the mine. We are determining how much the mine has been depleted, and to do that we want to know the value of the product in the mine, not after it has been refined.

Mr. Shafroth: Mr. President, I want to state to the Senator from California the situation as it existed at the time this provision was adopted.

The committee had made the rule applicable to coal mines, giving them the right to a reasonable allowance for depletion, not to exceed the market value in the mine of the production thereof, but had made a different rule as to metalliferous mines, namely, the rule of reasonable allowance, not to exceed 5 per cent of the gross value at the mine of the output of the year. Now, that is a very indefinite thing. It is only for one year—5 per cent for one year—whereas, if we are entitled to anything, we are entitled to the value in the mine of the ore taken out that year. When the attention of the caucus was called to it, they readily conceded that that part of it should apply to the entire provision, the reasonable value, the same as in coal mines. Consequently, we struck out the word 'coal' and made it 'mines,' so that it would be applicable to all mines, for it can be ascertained just as readily in the case of metalliferous mines as in the case of coal mines.

As to the oil provision, the Senator from West Virginia (Mr. Chilton) who knows a great deal about this subject, wrote the amendment himself, explained it, and it was adopted, and I think it is a good provision.

Mr. Chilton: Mr. President, I wish to say to the number of the committee having this matter in charge that as to clause (a) on page 36, which was passed over, the conclusion has been reached that it is all right as it is written. The Senator from California (Mr. Phelan) does not want to pursue the matter any further, and the amendment may be adopted without further amendment."

VI.

MINING OF NATURAL DEPOSITS IS A LIQUIDATING BUSINESS, CONSUMING CAPITAL, A "SELF-CONSUMING PLANT."

The business of mining ore as to the lessor with a royalty or by the lessee who has subleased on a royalty, is as to the ore purely a liquidating business, consisting of the gradual conversion of the minueral capital in the ground into money, upon which conversion, as to the mineral in the ground it can be determined whether there has been a gain or profit upon the transaction.

Those who were enacting the law, as we have seen under the proceedings in the Senate, had no doubt that the taking out of ore and the disposition of it was as to the market value of the ore in the ground a conversion of capital, and it was stated in so many words that the reasonable allowance for depletion not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, was intended, and was absolutely fair, because it separated the exact amount of the depletion of the mine, because it did not allow for anything that had been put upon the product of the mine in the way of labor or refining processes. It gave simply the value of what is taken out when it is in the mine with no labor put upon it nor other expenditure.

This proposition of consumption or conversion of capital seems self-evident in the case of any natural product or natural deposit from which extraction or a taking is begun while it is in its natural condition. It seemed self-evident to Congress.

If an authority is necessary for this proposition, it can be found in *Von Baumbach* v. *Sargent Land Co.* 243 U. S. 525, where the court said:

"True, the value of the mine is lessened from the

> partial exhaustion of the property, and, owing to its peculiar character, cannot be replaced. But in no accurate sense can such exhaustion of the body of the ore be deemed depreciation. It is equally true that there seems to be a hardship in taxing such receipts as income, without some deduction arising from the fact that the mining property is being continually reduced by the removal of the minerals. * * *"

The court refers to the income tax acts, and points out that

> "in the Income Tax Law of September 8, 1916 (1915-1916 Stat. 756, 769) a reasonable allowance is made in the cases of mines for depletion thereof 'not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made.'"

There is no question that under this language the court recognizes that the thing that is being depleted is the ore body in the mine; the depletion consists of the taking away of a portion of the ore. That depletion in a particular year is measured by the market value when in the mine of the product of ore during the year. That market value is the measure of the depletion for that year. But that depletion is not necessarily all allowable, for depletion on that ore capital extracted cannot exceed its March 1, 1913 market value, because depletion is restoring to the owner, his capital value. There is also no question that this court has recognized that, to the extent of the extraction or taking of a natural product for a particular year, capital has been converted into money during that year.

In the case of *Doyle* v. *Mitchell Brothers Company*, 247 U. S. 179, the court was deciding a case involving a natural product as capital, where the Commissioner of Internal Revenue had allowed a deduction of the cost of the standing timber in 1903. He had refused to use the

fair market value of the natural product on December 31, 1908, the date of the act going into effect. The ideas of the court seem to have become more clarified upon the subject of one kind of natural product, because the attention of the court had been brought to the nature of any natural product being worked out, which in this case was standing timber. And now the court says (p. 183 of the opinion):

> "When we come to apply the act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the act, questions of difficulty are encountered. The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.'"
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> "The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect, and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into incongruity with the latter. If the gross receipts upon such a conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest, and taxes. There is no express provision that even al-

lows the merchant to deduct the cost of the goods that he sells.

Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, 415, 58 L. ed. 285, 292, 34 Sup. Ct. Rep. 136: 'Income may be defined as the gain derived from capital, from labor, or from both combined.'

Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.''

It was held, therefore, that as to depletion of a natural product or natural deposit, the market value of the date of going into effect of the act or as fixed by the act, was the basis of ascertaining gain on a disposition of capital; it is now fixed law that the general date for income tax laws, March 1, 1913, is the date at which the basic market value for ascertaining gain or loss is to be determined.

The court in the Von Baumbach case, *supra,* and also in this case of *Doyle* v. *Mitchell Bros. Company, supra,* made an effort to discriminate between a natural product growing on the top of the ground except as to the roots

of the timber, and a natural product below the surface of the ground, but that distinction is not at all convincing. It certainly was not convincing to Congress because the act under which this case is being argued applying to the year 1917 said in so many words that a depletion should be allowed for the market value in the mine of the product that is converted during the year of return, and the statute applying in 1918 to the return for that year wipes out the distinction theretofore made between natural products by putting standing timber, ore in the mine, and other natural deposits upon precisely the same level.

It seems, then, that it is settled by the decisions of this court that in the case of iron ore mined and sold during the year, there is a conversion of capital to the extent of the market value of the product in the mine of the ore extracted and disposed of during the years as of March 1, 1913, under the terms of one of these mining leases.

VII.

CONSTRUCTION GIVEN TO STATUTE MUST BE ONE THAT WILL ALLOW CAPITAL TO BE RETURNED.

An income tax statute which takes any part of the capital as income is unconstitutional.

Eisner v. *Macomber*, 252 U. S. 189, 205; 64 L. Ed. 521, 528.

The ore severed in mining is "something of exchangeable value severed from the capital" and its market value in its natural condition on March 1, 1913, compared with its market value at the time of extraction, represents what is severed from capital in the terms of exchangeable value, and it is at that date of extraction not only severed from capital but exchanged into money, as we shall next show under subdivision VIII of this brief.

This court in the last cited case shows that exchangeable value must necessarily be based on market value, if market value is ascertainable.

VIII.

CONSTRUCTION OF THE STATUTE IN FORCE IN 1917 AS APPLIED TO THE TRANSACTION, INCOME FROM WHICH WAS SOUGHT TO BE TAXED.

In order to apply the statute to the transaction of extracting ore under a lease, it is necessary, first, to ascertain what the transaction amounts to in point of gain, profit or income, when royalties are paid by lessee to lessor for ore taken out of a mine under the terms of these mining leases, keeping in mind that the acts tax income alone in the transaction.

This situation is no longer an open question under the decisions of this court, as we shall show. But to enter upon the question properly, it is necessary to point out that there is a settled rule applicable to these leases which is of fundamental importance. Such a lease as is here in question gives no title to the lessee in the ore bodies at the time of the making of the lease, nor so long as the ore remains in the ground unextracted. *Lynch* v. *Alworth-Stephens Co.* 267 U. S. 364, 369. Such a lease, however, confers upon the lessee a substantial right in property, which is certainly a property right. The lessee has no title to any of the ore until he reduces it to his ownership by extraction.

In this case last cited the court said:

> "The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of the lease here involved so long as he sees fit to hold the same without exercising the privilege of cancellation therein contained."

The court in the case just cited refers to preceding cases to show that as long as the ore remains unextracted in the mine, there is nothing but a right giving no present title to the ore bodies, and cites *U. S.* v. *Biwabik Mining Co.* 247 U. S. 116, 125, 126; 62 L. Ed. 1017, 1021.

There is then at the making of the lease no sale of ore and no passing of title thereof, which could form the basis of a transaction disposing of capital, except as the beginning of a transaction unconsummated. But there must be, since the lessee converts and sells the ore as his own (and has the right to do so), a time when the ore extracted ceases to be the property of the lessor and becomes that of the lessee, and this time must be when it is severed from the soil of the mine, is reduced to exclusive possession as personalty by the lessee and is subject to sale by the lessee. Thereupon the ore ceases to be a part of the real estate and has become, of course, personal property. This point of time the statute seizes upon, and correctly does so, as the disposition of capital assets. This is proven by *Lynch* v. *Alworth-Stephens Co.* 267 U. S. 364, 369, where the phrase is used "market value in the mine of the product thereof *mined* or *sold* during the taxable year," and the statute uses the same words "value in the mine of the product thereof which has been mined and sold during the year." The sale is made during the year of extraction and upon extraction.

At that time there takes place "the sale or other disposition of property" under the statute, Sec. 2 (a) of the Act of September 8, 1916, quoted *supra,* and under the statute Sec. 202 (a) of the Act of 1918, quoted *supra,* which statutes, are, as to these words and this provision, identical in their terms. The capital asset disposed of is only the year's extraction, but none of the other ore

in the mine. Upon the then completion of this transaction of the year's extraction it is to be ascertained whether upon such disposition of property there has been a gain or profit or a loss. This is true as between lessor and lessee; and under *Lynch* v. *Alworth-Stephens Co., supra,* and under the statute, since it is at this time that the ore has been converted, it must be ascertained then and there what is the whole amount of depletion chargeable against the transaction as the cost value of the capital asset converted and disposed of, and that whole amount, according to *Lynch* v. *Alworth-Stephens Co., supra,* must be equitably divided between lessor and lessee under the law applicable in 1917 and by the express terms of the statute, under the law applicable in 1918. The statute of 1917, therefore, implied what the statute of 1918 expressed.

Up to the time of extraction of ore the right of the lessee to explore and take out ore and the reciprocal right of the lessor to receive royalties thereon have resulted in no realization of a gain or profit or loss and in no severance of any ore of exchangeable value as to the ore remaining in the mine. The provisions of the lease have remained purely executory as to ore in the mine and the transaction as to that ore has been *in fieri.* The property which is the subject of disposition is iron ore, and up to that time of severance and extraction it has remained the property of the lessor, but at the time of extraction, the ore extraced passes as personal property to the lessee. As to that ore actually extracted the lease is no longer executory but is executed. As to that ore extracted nothing remains to be done except to pay money.

The first provision of the statute that must be applied and given its effect, as to the transaction, is the general provision both for 1917 and 1918 in regard to the gen-

eral disposition or sale of property ("a sale or other disposition") of the statute, for the ascertainment of a gain or loss. The fair market value of March 1, 1913, of that ore disposed of, which is the subject of the transaction, must be compared with the market value of that same ore in the year of its extraction, such market value in both instances to be the market value of the ore as it stood in the mine, without any labor put upon it, it not being questioned that the lessor had acquired and owned the property on March 1, 1913, and the lease being then in existence. This sale shows "a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in, being derived,* that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal, *that* is income derived from property. Nothing else answers the description." *Eisner* v. *Macomber,* 252 U. S. 189, 207.

The next provision of the statute that is to be applied is the special provision on the subject of depletion and the allowance therefor, and it is plain that these two sections of the statute must be reconciled and must be made congruous with each other. No authority upon statutory construction is needed to be cited here upon this general proposition of statutory construction beyond *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 179, quoted *supra,* as to avoiding an incongruity. The depletion section is reconciled and is reconcilable with the general statute for ascertaining gain. The depletion provision states that the depletion shall "not exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made." This provision establishes first a legal standard of depletion, namely, the market value of the year's product of the mine; second, a limitation of

depletion, namely, that it shall not exceed the market value in that year of the ore extracted, third, that the ore extracted during that year is the capital asset sold. Now, since the general statute, under the Constitution, requires that nothing can be taken as income which is capital, it is apparent that these two sections taken together mean that the depletion shall not exceed the market value of the product of the mine in the mine during the year, but that allowance for depletion also shall not exceed the market value of that same ore in the mine on March 1, 1913. This is carried out in the proviso to the depletion provision, quoted *supra,* that when the allowances for depletion shall equal "in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made." On this method it is absolutely certain that allowances for depletion can never exceed the market value of the total ore in the mine on March 1, 1913.

But it may be said that if the market value upon disposition in the year of extraction does not equal the market value of March 1, 1913, the taxpayer has suffered a loss. If so, the statute has provided for losses both in business and not in business as deductions from gross income, and all the provisions are made to agree.

The problem of applying the law to the transaction, therefore, if there were no more to the transaction, would be the simple one of proving as a fact by competent evidence the market value at extraction of the tonnage extracted during the year of the return as the ore stood in the mine, and then proving the market value of that tonnage extracted as it stood in the mine, untouched and with no labor upon it, on March 1, 1913, which market value on March 1, 1913, cannot be exceeded in allowing for the depletion of the ore bodies during the year of the

extraction but must be allowed in order to restore capital.

To state the proposition in another way, this market value of such extracted tonnage in the year of extraction cannot be exceeded because the ore as a capital asset cannot be worth more than that market value, and depletion for that year's extracted ore cannot exceed the worth of that ore, when extracted. But the market value of that year's extracted ore cannot exceed the market value as of March 1, 1913, for under the statute all the increment of market value on that extracted ore over March 1, 1913 is gain or profit on capital and is under the statute all that can be allowed for depletion. No matter how much the market value of tonnage during the year of the extraction may exceed the market value of March 1, 1913, the depletion cannot exceed the market value on March 1, 1913; and depletion under no circumstances can be anything more than what the statute has determined to be the cost of that tonnage, namely, the market value of that particular ore in the mine on March 1, 1913 and must be that unless the payment of royalty contains within itself some other profit on capital, such as interest.

Yet the whole transaction in regard to the ore between the lessor and lessee has not yet been stated. Another consideration enters into the ascertainment of gain or loss and depletion.

IX.

LIMIT OF LESSOR'S INTEREST.

There is here a situation of rights created as of March 1, 1913. The right given to the lessee to extract is a valuable property right. The lessor has retained his ore,

it is true, but subject to the right given to another to extract it upon payment of twenty-five cents per ton on extraction and conversion. The leases were all made before March 1, 1913, when the statutes applicable to income tax took effect, and on March 1, 1913, the utmost of the market value of that ore in the mine, if afterwards extracted under the lease, is twenty-five cents per ton to the lessor. All market value exceeding the twenty-five cents per ton has upon extraction been granted to the lessee, and the total capital of the lessor in the ore is twenty-five cents per ton. All capital value in the ore actually extracted, when extracted, beyond twenty-five cents per ton on March 1, 1913, belongs to the lessee, the lease being then in existence.

Hence the lessee has the right to a part of that market value on March 1, 1913, if the market value on March 1, 1913, of those tons of ore exceeded twenty-five cents per ton. This diminished value of the lessor in the market value of the ore on March 1, 1913, which is imposed by the lease, does not affect the total depletion. It simply shows that the lessor's part of the depletion cannot exceed twenty-five cents per ton, because that is the utmost of his capital asset in the market value of the ore, if it shall be extracted under the lease. What may be the depletion of the lessee in these years we are not concerned with settling here. If the proof is that the market value of the tonnage extracted was at least equal to twenty-five cents per ton, and the market value in the year of extraction of that tonnage extracted was at least eual to twenty-five cents per ton, the lessor is no further interested because those comparative market values give him his utmost return of capital, and he is taking no part of the lessee's interest in the March 1, 1913 market value.

This equitable division of the total depletion is implied in the statute applicable to the year 1917 as decided by *Lynch* v. *Alworth-Stephens Co.* 267 U. S. 364, and is expressly provided for in the statute applicable to 1918, which provides: "In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between lessor and lessee." The statute thus recognizes the rulings of the courts.

This court has ruled in *Lynch* v. *Alwort-Stephens Co.* 267 U. S. 364, that the total depletion must be based upon the fair market value of the ore in the mine extracted and sold during the year of the return, not exceeding the fair market value of the same ore on March 1, 1913. The opinion is careful to quote the general provision as to return of capital as controlling. If, then, the fair market value of ore extracted should be seventy-five cents per ton on March 1, 1913, and seventy-five cents per ton in the year of extraction, and the limit of the lessor's value in the market value of the tonnage is twenty-five cents per ton, the rest of the market value depletion is the property of the lessee unless he has in turn leased, in which event how much of it the lessee owned would be determined by the royalty to be paid by the sublessee, as to whom the lessee is lessor.

X.

THE DEFERRED ROYALTY PAYMENTS FROM MARCH 1, 1913, CONTAIN INTEREST AS AN EARNING ON CAPITAL.

There is yet another circumstance which has not been adverted to that affects the transaction so far as income tax is concerned. The general provision of the income tax statutes requires every gain on capital and every gain or profit on every capital transaction where capital

has been sold or disposed of or made use of to be accounted for by the taxpayer. Among the gains is interest on capital. These leases for the purpose of the income tax are considered as going into effect on March 1, 1913. If in the year following March 1, 1913, all the ore had been converted, the depletion of lessor would have been easy of computation under these proofs in the case. But the leases made it possible for the lessee to defer the payment of twenty-five cents per ton extracted by deferring the year of extraction, and thus by deferring the perfecting of his present obligation, to pay money when he did extract ore. But under the law a lease of ore is not a conditional sale of the ore. The present agreement to take twenty-five cents per ton for that ore, if extracted, simply amounted to saying that the lessee might defer the payments of moneys to become due under these leases *without interest,* until the time comes at which the lessee extracts the ore. Hence, if the lessee does defer and pays no interest, during deferment, that twenty-five cents per ton, if he does pay it, he pays both for the ore and for the deferment. When any extraction has been made there results under the law and under the terms of the lease a promise to pay money for that particular extraction, which the statute divides into years, and which promise inchoate when made, became absolute when extraction of ore was made; that is to say, an actual finished transaction, only as to the ore extracted. The leases could have been drawn with the provision that when ore was paid for, it should be paid for at twenty-five cents per ton with interest thereon during the period of deferment. In such case the interest would have been clearly an earning or gain on capital when the interest was paid. But the promise was not so conditioned. Moneys to become due upon extraction drew no interest. The payments were and would necessarily be payments

based on ore actually extracted and sold, whatever the amounts of yearly or quarterly extraction should be.

There is a principle of law which applies here, well settled under income tax laws, that a deferred payment drawing no interest, contains within itself, when paid, two elements, a payment of a principal sum and a payment of interest on that principal sum, the gain of interest during the period of deferment.

Foley v. *Fletcher,* 3 H. and N. 769.
Secretary of State v. *Scoble* [1903] A. C. 299; [1903] 1 K. B. 491.
Tiernan v. *Hinman,* 16 Ill. 400.

Hence, when the lessees paid the lessors for ore extracted in 1917, if the lessees were otherwise entitled as depletion to the market value of twenty-five cents per ton on March 1, 1913, the lessees were actually receiving in the payments of 1917 and 1918 a principal sum paid for capital and interest on that sum for the period from March 1, 1913, to the date of actual payment. The principal and interest are very easily ascertained by dividing the sum paid in 1917 into its one part of a certain sum of principal and its other part of interest on that sum from March 1, 1913, to the date of payment. The total of principal and interest exactly equals the payment made, which has been deferred. The interest in it is a clear earning of interest on a capital asset. The rate in the calculation here is five per centum.

The lessor in this case cannot claim his whole twenty-five cents on this transaction as depletion, because the moneys he has actually received contain an amount of gain or earning on a capital asset, and that gain can be treated in one of two ways, the whole twenty-five cents may be allowed as depletion, on each ton extracted, or the interest may be deducted from the depletion, other-

wise allowable. The result is precisely the same in amount of tax. The interest, the gain on deferment, should be added to gross income, if it is not deducted from depletion. But it is better that this element of interest should be deducted from depletion because the spirit of the statute is to ascertain what amount should be allowed as depletion for the actual decrease of capital, not reimbursed, as it has been decided.

Doyle v. *Mitchell Bros. Co.*, quoted *supra*, where it is said: "It may be observed that it is a mere question of methods, not affecting the result, whether the amount necessary to be withdrawn in order to preserve capital intact should be deducted from gross receipts in the process of ascertaining gross income or should be deducted from gross income in the form of a depreciated account in the process of determining net income. In either case the object is to distinguish capital previously existing from income taxable under the act." The result in amount of tax is precisely the same. In the payment of the royalty the utmost allowance for decrease of capital is the market value of the ore less earning on the principal or capital involved in that ore.

There results automatically from this method that the depletion allowed can never exceed, and in fact must fall far short of either the market value of the ore on March 1, 1913, or the market value of the ore at the date of extraction. In the end the actual ore extracted for successive years in market value would equal to the lessor his portion of the market value of March 1, 1913, but the depletion allowed in total could never reach that market value because each payment would have a deduction for interest taken from the depletion. Thus the provision of the statute is fulfilled that total depletion for both lessor and lessee can never exceed market value of the

ore on March 1, 1913. Every applicable section of the statutes has been given full effect and they are plainly reconcilable. The exact nature of the transaction as it is fixed by the decisions has not been deviated from, and absolute justice, if such an ideal exists, has been attained.

XI.

MARKET VALUE OF ORE AS A STANDARD.

Up to this point it has been assumed that the words "market value" have a well-known and particular significance in the law. Perhaps this significance in the income tax statutes should be now more fully explained. It may be unnecessary, but the explanation may be excused as a statement made *ex abundanti cautela,* because in this case the Government counsel in the trial court denied the legal meaning of "market value."

In the income tax statute for 1917 and for 1918 quoted above, the general words expressing and defining the standard to be used for the allowance to be made for depletion are: "the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made." The statute in force for 1918 placed the allowance for depletion upon original cost, provided that in the case of properties acquired prior to March 1, 1913, the fair market value of the property or the taxpayer's interest therein on that date shall be taken in lieu of cost up to that date. The same words "market value" as of March 1, 1913, for property owned on March 1, 1913, are used in the statute for ascertaining the gain or profit upon capital or property after March 1, 1913, disposed of or converted. It will thus be seen that the particular

provision of the statute for 1917 on depletion is made by the statute for 1918, simply a particular case under the general provision as to gain or loss upon a conversion of capital assets.

The words "market value" have a well-known and fixed significance in the law. They import a fact to be testified to by witnesses whom the law recognizes as cognizant of the fact; they import that the fact shall be proved by those who have experience as to the particular property in the particular market, knowledge of the standard to be applied in the particular market, and knowledge of the object to be valued. The witness, after his qualifications and knowledge are shown, testifies to the market value as a fact. If he says that he knows the market value, he is then asked what it is. This is so stated in *Montana R. Co.* v. *Warren,* 137 U. S. 348, 354.

In this case it is said:

> "After a witness has testified that he knows the property and its value, he may be called upon to state such value. The means and extent of his information, and therefore the worth of his opinion, may be developed at length on his cross-examination. And it is fully open to the adverse party, if not satisfied with the values thus given, to call witnesses in the extent of whose knowledge and the weight of whose opinions it has confidence."

1 Wigmore on Evidence, pp. 809-819, Secs. 711-721, has a statement on the subject of the authorities and of the rule.

The statutes, therefore, have established, first, that the depletion consists of ore extracted in a particular year; second, that the standard in the matter of ascertaining gains and profits and depletion consists of a particular kind of evidence, namely, market value of ore in the ground, and no other standard is allowed or suggested to be used or substituted.

XII.

APPLICATION OF THE LAW BY THE LOWER COURT TO THE PROOFS IN THIS CASE.

All the facts required to be shown in evidence under the preceding statement of the law were presented in the record to the District Court as shown by the statement of the case *supra*. The only item in dispute was depletion. The allowances made by the Government for depletion were shown, and the payments by the plaintiff of her assessments on those allowances made by the Government were shown by her checks cashed and returned. The quarterly payments to plaintiff of royalties were shown, and the tonnage extracted in each year was shown with the total quarterly payments therefor to this taxpayer for her one-sixth.

Then three witnesses were called, Mr. Savage, an iron ore mining operator living in the district and acquainted with the ore; Keith, an expert geologist and statistician, thoroughly acquainted with the district; a third, Ives, an iron ore buyer of the district; who each testified that he knew the character of the ore in these mines as merchantable iron ore; that that ore had a market value, that he knew the market value of that ore by the ton in the mine, untouched and unextracted, on March 1, 1913, and during the period from March 1, 1913, to 1917 and 1918, and during the years 1917 and 1918, and at and during those times at that place that market value was at least twenty-five cents per ton, and that this was regardless of who owned the ore or what lease was upon it. No question was made that this evidence was impeachable or capable of contradiction and no attempt to detract from it was attempted on cross-examination.

Then by calculations the amount of the tax payable was arrived at, by calculating depletion at twenty-five cents per ton on the actual extraction subtracting therefrom the interest in the payments when they were made, as deferred from March 1, 1913. The calculation of interest in the payments was shown, and there was no question made as to the figures. Then the proof was made as to the overpayment and those figures were not in dispute on the preceding method of ascertaining depletion.

XIII.

INSUFFICIENT ASSIGNMENTS OF ERROR.

Both plaintiff and defendant then asked for an instructed verdict without more, which action submitted the case to the court for decision. The court rendered a general finding and the sole question is whether there is any evidence to support the verdict.

Beutell v. *Magone*, 157 U. S. 154.
Empire State Cattle Co. v. *Atchison, etc., R. Co.* 210 U. S. 1, 8.

We may state in passing that none of the assignments of error seems to touch the question decided by the lower court on the evidence. The sixth assignment of error does not assert that there is no evidence to support the verdict. It does not even assert that the lower court did not base its decision upon evidence. It does not point out any statute wrongfully construed. No one can tell what is meant (R. 154) by the words "the fair market value as of March 1, 1913, of the plaintiff's interest in said mine," unless it be the fair market value of the plaintiff's one-sixth of the ore in the mine. But that is precisely the rule followed by the court. What plaintiff de-

sires to contend for, apparently, is that the calculation should have been an attempt to ascertain, in an arbitrary way by arbitrary assumptions, the assumed selling value of the lease on March 1, 1913. These assumptions have no connection with the standard of the law. The statutes say and this Court has decided that the standard to be used is the market value of the ore in the mine. In the discussion, since the court has allowed a certiorari, we pass the point of no proper assignment of error but do not waive it.

XIV.

THE RULE AS TO DEPLETION TO BE FOLLOWED HAS BEEN SETTLED BY THIS COURT.

In *Lynch* v. *Alworth-Stephens Co.* 267 U. S. 364, the question arose under the law applicable in 1917. The Alworth-Stephens Company was lessee in iron ore mining leases made prior to March 1, 1913, reserving a royalty of twenty-five cents per ton. The Alworth-Stephens Company had subleased, prior to March 1, 1913, its rights at a royalty of seventy-five cents per ton for one tract and of sixty cents per ton for the other tract. As to the sublessee the Alworth-Stephens Company was lessor and the case is, therefore, an authority on both lessor and lessee. From March 1, 1913, during the entire time, the market value of the ore in the mines exceeded seventy-five cents per ton (pp. 366, 367 of the opinion).

The Government contended "that the leases do not convey to the lessee the ore bodies, but are contracts of rental conferring only the right to use and occupy the premises and mine the ore, which, so long as it remains in the ground, is the property of the fee owner. It was therefore insisted that by the extraction of the ore, only

the property of the fee owner is depleted and such owner alone is entitled to allowance therefor."

It will be noted that the contention of the Government then was directly contrary to what it is now, since now they contend for a sale of all the ore in the ground as of March 1, 1913, disregarding the decisions.

This court held, however, that while it was true that the leases conveyed no title to the unextracted ore deposit, it was also true that the fee owner (first lessor) and the first lessee, Alworth-Stephens Company, had each a property right under the leases. Then the statute of 1917 on depletion was quoted, and it was said (p. 370) that "as the process of extraction goes on" the property interest of both lessor and lessee is depleted.

> "There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent deduction to be made, in each, is to be arrived at in the same way; namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, allocating that amount in proportion to the interest of each, severally considered."

Here we wish to emphasize the phrase "based upon the market value of the product" as the rule for depletion.

The principle of this division (p. 369) is that

> "by the terms of the statute each is entitled to deduct from gross income a reasonable allowance for depletion, the lessee for exhaustion of the leasehold interest and the lessor for the exhaustion of the fee interest as lessened by the interest of the lessee, such deduction to be allowed according to the value of the interest of each in the property, the entire allowance, however, not to exceed the total market value in the mine of the product thereof mined and sold during the taxable year."

Thus it is plainly decided that the depletion is of the ore extracted, that the standard of depletion is the market value of the ore extracted, that the fee-owner gets of that depletion his market value in the ore as diminished by the lessee's interest, that the lessee gets the rest of the market value, that the total depletion must be determined for division between lessor and lessee and must not exceed the market value in the mine of the product thereof mined and sold during the taxable year and out of the total depletion there must be allocated to each of the lessor and lessee his depletion in proportion to his interest severally considered.

The court, while careful to quote the statute, does not advert to the consideration that by the general provision as to the disposition of property resulting a gain the depletion of capital cannot exceed the market value of the ore as capital on March 1, 1913. The point was immaterial, for in that case the market value was seventy-five cents per ton on March 1, 1913, and at all times thereafter, and the question could not arise of exceeding the market value of the ore on March 1, 1913. The same situation exists in this case now before the court.

The Alworth-Stephens Company as lessee was held entitled to deduct depletion under the above rule stated in the opinion at 71.9 per cent of its gross receipts for its royalties as sublessor. Its royalties from its lessee it must receive as a lessor as to the sublessee, before the sublessee gets any depletion. The same rule necessarily applies between original lessor and first lessee which became sublessor. The original lessor was by the same rule held entitled to depletion on its interest in the ore, but no question seems to have been made as to how the figures were arrived at or as to the amount of the lessor's depletion. Certainly the lessor's depletion would have

been taken care of in the other 28.1 per cent of the total royalties of seventy-five cents and sixty cents per ton not allowed as depletion to the lessee. It goes without saying that the lessor's depletion must be taken care of under the rule before any depletion can be granted to the lessee, since the opinion states that the lessor gets depletion for his interest as lessened by the lessee's interest.

In the case the Government's counsel allowed to escape the interest in the deferred payments as income, but proceeding on a conspicuously wrong theory of the law, it never seems to have occurred to them.

If, now, the rule stated in the opinion as to the respective depletions of the lessor and lessee is applied to the Government's contention in this case, the rule of calculating depletion contended for by the Department is manifestly impossible to be applied. The lessee in the instant case, under the Government's contention, cannot get any depletion. The lessor has an interest of twenty-five cents per ton. The depletion allowed is only 8.8. cents per ton, and this is the total depletion. All that depletion must be assigned to the lessor under the rule of the Department, leaving nothing for the lessee, which is a patent injustice.

Yet if it be taken as the fact in this case that in 1917 the ore extracted had a market value of seventy-five cents per ton and only twenty-five cents of that market value could be apportioned to the lessor, the lessee had, of the market value lessened by the lessor's interest, a capital interest of fifty cents per ton, which theretofore inchoate, became actual as to ore extracted in that year of 1917; and this must be so because on March 1, 1913, the market price per ton was seventy-five cents, twenty-five cents of which capital was appropriated

to the lessor's interest, and fifty cents of which was appropriated to the lessee's interest, but in both cases only upon extraction. Now the *Alworth-Stephens Company* case says that the whole depletion must be ascertained "by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, and allocating that amount in proportion to the interest of each, severally considered." The Department in the instant case pays no attention to this ruling, but insists on its method which contradicts statutes and decisions. *Lynch* v. *Alworth-Stephens Co., ubi supra,* shows that the promise became absolute upon extraction and the passing of title in the ore extracted, but only as to the ore extracted.

The only way in which the Department can avoid the manifest absurdity into which its method of ascertaining a depletion unit reduces its whole calculation of a depletion unit is to say, we will make one calculation to ascertain the problematic value of the lessor's lease, and we will take the original lessee's sublease and treat that as a separate matter as another lease and by our arbitrary rules assuming so many years of equal yearly extraction, calculate the depletion unit for the first lessee, become sublessor, on the basis of his reserved royalty of seventy-five cents per ton. But here a difficulty will be encountered, for the royalty paid by that first lessee to the original lessor is an expense to the lessee. He is entitled to deduct it as an expense. It is plain why the statute construed in *Lynch* v. *Alworth Stephens Co., supra,* lays it down that the total depletion must be ascertained for all the interests. If the Department says that it will take the margin of the lessee's reserved royalty over the lessor's reserved royalty, the result is no better, for the statute contemplates but one depletion

calculated on the market value of the ore in the year of extraction, not exceeding the market value on March 1, 1913, and a division on equitable terms of that whole depletion between lessor and lessee, and this court has so decided.

When the case comes to the depletion of the sublessee, another calculation under the arbitrary rules of the Department Engineers must be made. So that in the end the simple method stated by the statute is resolved into an arbitrary calculation as a separate thing for the lessor, another like arbitrary calculation for the lessee (sublessor), another like arbitrary calculation for the sublessee. The ore, in which title is passing only upon extraction, is divided into three separate estates or interests, arising and made perfect as an actual ownership, one at the making of the lease, another at the making of the sublease, each with a separate depletion unit, and the lessor under no circumstances can get his capital back, while at the same time large depletions are allowed to the lessee and sublessee. On this method the lessor's depletion unit would be 8.8 cents per ton, the lessee's say 17.6 cents per ton, and the sublessee's, say 5 cents per ton, 31.4 cents per ton in all, and the lessor, who is first entitled to depletion, gets at 8.8 cents per ton only about a quarter of the total depletion, when in fact he was entitled to 25 cents per ton, less interest in the royalty payments.

It would seem, then, that the lower court followed the proper rule as adjudicated by this court. The proof was so made that the amount of only the lessor's depletion was shown, and not the amount of the lessee's depletion, but no part of the lessee's depletion was taken. If, now, on the Government's contention, the total depletion is to be assigned to the lessor and that depletion is only 8.8 cents, when the lessee comes to ask for his depletion he

will be met by the suggestion that this court has so adjudicated this question that the lessee can get no depletion. Thus the well considered case of *Lynch* v. *Alworth-Stephens Co., supra,* would be wholly nullified.

Under the law of 1918, depletion of mines, oil and gas wells, other natural deposits and timber, are all put on the same basis, and the question is settled by the statute. The statute requires the total depletion in the case of leases to be ascertained and equitably apportioned between the lessor and lessee, and this court has told us what this equitable apportionment must be under the law of 1917 as well as of 1918.

There is an opinion of this court which states the rule as to timber and necessarily states the rule under the statute for mines. There is no difference between the two things, both iron ore and growing timber are capital, stored up by nature, except that one is below the surface and the other above. The case now to be noticed has under the statute of 1917 and of 1918 become an authority on iron ore extracted.

In *Doyle* v. *Mitchell Bros.* 247 U. S. 179, 62 L. Ed. 1054, this court had before it a case involving the gain or income from cutting standing timber. The timber company deducted as an allowance from gross income from cutting and selling timber, the market value as of December 31, 1908 (the date for going into effect of the provisions of the then applicable statute) of the timber as uncut stumpage, the natural product standing on the ground in its natural condition. This market value was proven to be on March 1, 1913, $40 per acre. There is no more trouble in proving the value of uncut timber by the acre at a particular time and place than in proving the value of a ton of ore of homogeneous character, standing untouched, at or under the surface of the ground

as to which the statute says impliedly: "If you have not in your mine, the prophesied ore, you will never be required to consider it capital."

The case of *Doyle* v. *Mitchell Bros., supra,* was treated as a case of conversion of capital assets, just as the statutes of 1917 and 1918 treat ore in the ground and other natural deposits. The court said:

> "When we come to apply the act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the act, questions of difficulty are encountered. The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.' "

The Department in that case presented a formula, so called, and of it the court said:

> "The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect, and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into incongruity with the latter. If the gross receipts upon such a conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest, and taxes. There is no express provision that even al-

lows the merchant to deduct the cost of the goods that he sells."

Then the court, later in the opinion, further said:

"The plaintiff, in making up its income tax returns for the years 1909, 1910, 1911, and 1912, deducted from its gross receipts the admittedly accurate valuation as of December 31, 1908, of the stumpage cut and converted during the year covered by the tax. There having been no change in market values during these years, the deduction did but restore to the capital in money that which had been withdrawn in stumpage cut, leaving the aggregate of capital neither increased nor decreased, and leaving the residue of the gross receipts to represent the gain realized by the conversion, so far as that gain arose while the act was in effect. This was in accordance with the true intent and meaning of the act."

This case shows that depletion consists of capital withdrawn in the shape of stumpage cut, measured by its market value, and the case holds, therefore, as an authority, that on a conversion of capital assets consisting of a natural product or deposit, when the question is of an income tax, the gain on the transaction, which gain is alone income, is to be ascertained by comparing the market value of the natural product as property in its natural state at the time for ascertaining value fixed in the act, with the market value of the same property at the year of the conversion of the natural product and the disposition thereof, and that the market value of the product in its natural condition must be deducted before there can be any gain or profit for the purposes of an income tax law. This is said to be entirely reconcilable with the proposition of earlier cases that if it is an excise tax of corporations and not an income tax that is in question, as was the case with mines prior to March 1, 1913, there need be no allowance for depletion in the fixing of the excise tax as to income from ore, nor does

the word "depreciation" cover depletion of capital assets, for the purpose of fixing the excise tax; and that such allowance is not required by the word "depreciation" since depreciation does not cover depletion. This was pointed out in *Lynch* v. *Alworth-Stephens Co.* 267 U. S. 364, 371; 69 L. Ed. 660, 663, where the court said:

> "We are referred to *Weiss* v. *Mohawk Min. Co.* 264 Fed. 502, where the circuit court of appeals for the sixth circuit reached an exactly opposite conclusion to that announced in the present case by the courts below. The opinion in that case was apparently made to rest upon the decision of this court in *United States* v. *Biwabik Min. Co. supra,* which, in turn, followed *Von Baumbach* v. *Sargent Land Co.* 242 U. S. 503, 61 L. Ed. 460, 37 Sup. Ct. Rep. 201. These cases, however, arose under the Corporation Tax Law of August 5, 1909, chap. 6, 36 Stat. at L. 11, 112, Sec. 38, 4 Fed. Stat. Anno. 2d ed. p. 255, imposing a special excise tax with respect to the carrying on or doing business by a corporation, etc., measured by its net income, in the ascertainment of which, among other things, there was authorized a deduction of 'a reasonable allowance for depreciation of property.' The *Sargent Land Co. Case* concerned the owner and lessor of mining property, while the *Biwabik Min. Co. Case* concerned a lessee of mining property. It was held in both cases, as we hold here, that the leases under consideration did not convey title to the ore in place. Whether the lessees had property interests such as we have determined here was not considered. Both decisions, expressly in one and implicitly in the other, turned, primarily, upon the scope of the word 'depreciation.' In the *Sargent Land Co. Case* this appears expressly from the following extract (pp. 524, 525): 'We do not think Congress intended to cover the necessary depreciation of a mine by exhaustion of the ores in determining the income to be assessed under the statute by including such exhaustion within the allowance made for depreciation. It would be a strained use of the term "depreciation" to say that, where ore is taken from a mine in the operation of the property, depreciation, as generally understood

in business circles, follows. True, the value of the mine is lessened from the partial exhaustion of the property, and, owing to its peculiar character, cannot be replaced. But in no accurate sense can such exhaustion of the body of the ore be deemed depreciation. It is equally true that there seems to be a hardship in taxing such receipts as income, without some deduction, arising from the fact that the mining property is being continually reduced by the removal of the minerals. But such consideration will not justify this court in attributing to depreciation a sense which we do not believe Congress intended to give to it in the Act of 1909.' And this view is immediately emphasized by putting in contrast with the 'depreciation' of the 1909 Act, the 'reasonable allowance for the exhaustion * * * of property' of the income-tax provision of the Tariff Act of October 3, 1913 (38 Stat. at L. 166, chap. 16, 4 Fed. Stat. Anno. 2d ed. p. 236), and the exhaustion and depletion provisions of the Act of 1916, heretofore quoted. 'These provisions,' the court concluded (p. 525), 'were not in the Act of 1909, and as we have said, we think that Congress in that act, used the term "depreciation" in its ordinary and usual significance. We therefore reach the conclusion that no allowance can be made of the character contended for as an item of depreciation.' "

It must be plain that the court in the case of *Lynch* v. *Altworth-Stephens Co., supra,* would not allow the *Sargent case,* distinguished therein, to be pressed beyond its plain application to an excise tax. Therefore it is settled that by the very terms of the laws for 1917 and 1918, where they establish the rule for the gain or income from sale or other disposition of property, the market value of March 1, 1913, must be compared with the market value of the date of such disposition by conversion. Unless the market value of the date fixed by the act is first withdrawn from income upon such conversion, there is a tax of capital as well as income, which is not constitutional.

The interpretation put by this court on the statute in *Lynch* v. *Alworth-Stephens Co., supra,* is the only interpretation that will reconcile all the provisions of the statute and give them all a proper effect, and that interpretation is reconcilable with the principle of other decisions of this court to the effect that if the taxable income from receipts for assets sold in any year includes any part of the market value of March 1, 1913, the law has taken capital as income and would be unconstitutional.

Eisner v. *Macomber,* 252 U. S. 189.

Doyle v. *Mitchell Bros. Co.* 247 U. S. 179.

XV.

THE CONTENTION OF THE GOVERNMENT AS SHOWN BY THE RECORD UPON THE LAW AND AS TO THE TRANSACTION OF THE PAYMENT OF ROYALTIES UNDER A LEASE MADE BEFORE MARCH 1, 1913, IS INADMISSIBLE.

So far as the record shows, the Government on the trial defined its position without making any suggestion as to the proper method to be followed until it made a motion for a new trial, which is not a reviewable proceeding.

When the plaintiff offered in evidence the computation of depletion by the Department in its letter upon which the tax was assessed and paid, the objection was made: "First, that the method used by the revenue agent has no tendency to show the method used by the commissioner, and, second, that the method used by the commissioner is entirely immaterial in this case" (R. 29). Later, counsel for the Government said: "Now if the purpose of these exhibits is to show that the commissioner make a mistake in applying his own method, then I am objecting" (R. 31).

The defendant's counsel upon the motion to instruct the jury (R. 17) stated as grounds for the motion that there was no legally sufficient evidence to show that fair market value as of March 1, 1913, of the plaintiff's interest in each of the mines, nor to show the estimated tonnage remaining in the mines at the end of the years 1916 to 1919, inclusive, respectively; that the method of plaintiff does not result in a reasonable allowance for depletion; that it is not in compliance with the commissioner's regulations, and that "the undisputed evidence shows that the allowances computed by the plaintiff are not a percentage of his capital invested equal to the percentage of the whole mineral content withdrawn during the year, and are not a percentage of his capital investment equal to the percentage of the unpaid royalties paid during the year for which the calculation is made."

This language it is difficult to understand. What the remaining estimated tonnage at the end of any year has to do with the question is not stated. The proposition that the allowances computed are not a percentage of the March 1, 1913 capital investment shown by market values equal to the percentage of the whole mineral content withdrawn during the year is untrue as a matter of fact. Assume the whole mineral content anything you please. The market value is twenty-five cents per ton to lessor. The amount withdrawn is valued at twenty-five cents per ton. The allowances computed are at twenty-five cents per ton less interest. The proportion is the same, since the multiplier is the same. The further proposition that allowances for depletion are not a percentage of capital investment that is the percentage of the unpaid royalties paid during the year to capital investment is also untrue. "Capital investment" are the words in which lurk the fallacy. The statute says "market value of March 1, 1913," is capital investment.

Counsel means capital investment to be something else. If for capital value you insert "market value of March 1, 1913," his proposition is precisely fulfilled by the lower court. The assumption of counsel is that that title to the estimated ore has by virtue of the lease passed to the lessee and this is proven by page 8 of petitioner's brief, where it is claimed: "The taxpayer's only interest in the properties on March 1, 1913, was that of lessor" and on page 12: "her rights were merely to receive the royalties stipulated in the leases and to obtain possession of the property on the termination of the leases."

The sixth assignment of error (R. 154) states probably what is the Government's contention. It is as follows:

> "6. Said District Court erred in refusing to hold as a matter of law that a reasonable allowance to the plaintiff in this cause for the depletion of the respective mines should be computed by dividing the estimated ore reserve tonnage on March 1, 1913, of each mine into the fair market value as of March 1, 1913 of the plaintiff's interest in said mine, and multiplying the dividends so obtained by the total tons of ore extracted from each mine, respectively, on which royalties were paid to the plaintiff during the taxable year for which the depletion allowance is claimed, provided that the aggregate of the allowances for the year 1917 does not exceed the fair market value in the mine of the ore which was mined and sold during that year, and provided further that the aggregate of the allowances made for previous years plus the amount of the allowance made for the year in question does not exceed the fair market value as of March 1, 1913, of the plaintiff's interest in the mine."

There is an error here in the word "dividends." Tonnage, the divisor, is being divided into market value, which is the dividend, the thing to be divided, and the word the Government's counsel intended to use is probably "quotients," the results of the divisions. It may be

noted in passing that this assignment is not equivalent to asserting that there was no evidence to support the judgment, which is the one assignment that could be made on this record.

The key to this cabalistic statement of counsel is what the counsel meant by "fair market value of March 1, 1913, of the plaintiffs' interest in the mine." This he does not explain. If he means what the statute said as to market value, he means market value of the ore in the ground and the interest of the taxpayer therein, which is here one-sixth of twenty-five cents in each ton, whatever the amount was in the ground. The method followed by the lower court exactly fulfills the condition stated in this sixth assignment of error, for the result would be twenty-five cents as the result of the division of tonnage into market value, and twenty-five cents applied to the tonnage extracted gives depletion of twenty-five cents per ton. But this cannot be what is intended by counsel, for he means to reject market value as a fact and by a calculation to show what he calls market value. His alleged market value attained by calculation is not the market value of the statute.

The department objected on the trial to the method of proving market value by competent evidence as to market value (R. 23). The Government contends that market value must be shown in another way. That way is indicated by the Commissioner's calculation (R. 128), said to be made by the Valuation Engineers of the Department but adopted by the Commissioner through his assistant. Counsel has totally overlooked the fact that his method requires another calculation for the market value of the lessee's interest.

The Valuation Engineers took the estimated tonnage on March 1, 1913, which is 188,382,892 tons, and the tax-

payer's interest of that is one-sixth, or 31,397,149.7 tons, belonging to the taxpayer on March 1, 1913. They recognize that her interest is in tons one-sixth of the tonnage, which is one-sixth of each ton.

Then they average the yearly extraction for all of the owners during the years 1913 to 1918, both inclusive, at 4,700,000 tons. How the taxpayer making up her return early in 1918 could possibly know the extraction in 1918, the Valuation Engineers wisely do not attempt to tell us, for that knowledge required for the taxpayer either waiting until a penalty has been incurred or prophetic omniscience. The Valuation Engineers divide that so ascertained average yearly extraction into the total estimated ore reserve, and forty is somewhere near the result. And they say that forty years is the maximum life of the mines. This is not fact, it is arbitrary assumption. But one of these leases runs for a term of twenty-five years, so that the assumption is contrary to the fact, and the unexpired portions of other leases differed and no unexpired term could reach forty years.

Then the Valuation Engineers took the total tonnage reserve on March 1, 1913, of the taxpayer, 31,397,149.7 tons, and multiplied it by twenty-five cents, the royalty reserved, and they said in those assumed forty years the total tonnage extracted will be absolutely and necessarily the whole reserve, which at twenty-five cents a ton for the taxpayer's one-sixth, will be $7,849,287.18. This is called "the capital sum returnable in forty years." (R. 128.) Is it not plain that the assumption is that the lessee has bought once for all the whole ore reserve in the land? Next they said that the present worth of this $7,849,287.18 returnable in forty years to this taxpayer is on March 1, 1913, $2,782,551.64, which amount they claim is the market value of all the ore in the ground on

March 1, 1913, under the terms of the statute. This figure they got by the Hoskold table, as the brief of petitioner on page 37 admits, for four per cent sinking funds with six per cent returns on capital to the taxpayer, opposite the number of forty for the year. The figure in the table is .354491 and if you multiply $7,849,287.18 by this .354491 you get $2,782,551.64 which they call present worth. Then they divided the total tonnage reserve of the taxpayer which is assumed to be as they stated (R. 128), 31,397,148.7 tons, into so-called market value present worth of March 1, 1913, calculated to be $2,782,551.64, and the result is the figure .088 with continuing fraction. This .088 is, they say, 8.8 cents, the unit cost per ton, March 1, 1913, to the taxpayer, the basis for depletion. Then they took the number of tons extracted for the taxpayer in the particular year and multiplied that by that unit of depletion so ascertained, 8.8 cents, and the result, they said, is the depletion in that year. Thus a depletion of 8. 8. cents per ton is equal to a market value per ton exceeding twenty-five cents. This result is not a fact; it is a fairy tale.

The point here is how they get at the "present worth" of the taxpayer's one-sixth of the ore as the figure which they have stated. The explanation is found (R. 141) in the following words: "The value of the total royalties to be received during life of mines discounted as of March 1, 1913, at 6% and 4% interest gives a unit value as of March 1, 1913, of .088 a ton." This calculation of discounting, the figures show and it is admitted, is the well-known method called Hoskold's Formula, which we shall now examine.

This formula is an adaptation of the old annuity formula reversed. It can be applied only where certain facts exist or where certain arbitrary assumptions are

made to fill the void of facts. The formula requires, first, moneys to be received in equal yearly amounts for a fixed number of successive years. These equal amounts to be received in each of the successive years must amount to a certain total sum which is known and fixed beforehand, here total prophesied royalties. Hence, to suit this formula the Government is compelled to assume, first, a fixed number of years for the extraction of ore, which they have assumed at forty years, no more and no less, and they call that forty years the life of the mines. Second, they must assume that extraction in each year will be just one-fortieth of the total ore reserve, no more and no less. They must assume that the estimated ore reserve is absolute and will all certainly be extracted in exactly equal yearly amounts for forty years. They must assume also that title in the entire ore body has passed by the lease to the lessee, that the lessee has the ore; all that remains to the lessor is a chose in action agreeing to pay money. They treat the transaction as a present sale at the time of the lease of all the ore and they strive to ascertain the present value of that entire sale.

So under the formula they take for each assumed year one-fortieth of the total royalties which they prophesy will be paid to the taxpayer over the whole assumed forty years in forty equal installments. They must assume this to make Hoskold's table apply. One-fortieth of this assumed total amount of royalties will be each annual payment to this taxpayer of royalties, which becomes approximately, by dividing $7,849,287.18 by forty, the sum of $196,232. Then, according to the formula, each one of the annual payments of $196,232 is divided into two parts when paid; one part is six per centum upon the present worth to be ascertained, the other part is the remainder of the annual payment. Now this remainder of

each annual payment is assumed to go into a sinking fund, and for each yearly payment that remainder of the annual payment is assumed to draw interest, and interest is calculated for the number of years it is to stay in the sinking fund at four per cent compounded yearly until the forty years have elapsed. Thus under this scheme at the end of the first year of royalties paid after March 1, 1913, the calculation is applied to a fixed amount paid in the year, $196,232. Six per cent on the present worth to be ascertained is, by virtue of the formula, to go to the taxpayer as a dividend. So if X be this present worth to be ascertained, .06X is six per cent on it, and the yearly payment of $196,232 minus .06X is the part of the remainder of that annual payment which will go into the sinking fund, and interest at four per cent, compounded annually, is calculated upon that amount of $196,232 minus .06X for thirty-nine years, and in the next year the annual payment being the same and the dividend to the taxpayer being the same, the calculation on the same sinking fund amount is for thirty-eight years, and so on down to the last year. Then all these various payments into sinking fund with all the interest calculated on each of them are added together, and that is said to be the present worth of the taxpayer's interest in the ore. This is what is meant by setting up a reserve. According to the Government the amount of 196,232 — .06X should be set up in the beginning for each year as a reserve by lessor. Interest and principal resulting from these calculations in forty years would be the present worth of the mine. The calculation works cut at $2,782,551.64. Thereupon they take the present worth so calculated at $2,782,551.64 and divide it by the taxpayers' total tonnage on March 1, 1913, of 31,397,148.7 tons, and the result they get is .088 with a continuing fraction, which is this mysterious unit of depletion. But the folly of it is that if you should take one hundred

years as the Hoskold figure to multiply by, your present worth would be practically *nil*. The depletion unit depends solely on the imagination of the figurer, the prophetic soul of a valuation engineer dreaming on things to come.

It is plain that this is a reversal of the annuity formula where a fixed amount is paid each year for the life expectancy number of years, and a calculation is made to find what amount must presently be paid for that annuity so that at the end of the time the payer of the annuity will have paid a fixed amount per year to the annuitant, and will have enough money out at interest, with interest on it to the end of the life expectancy period, to make the payer of the annuity whole.

These figures of the Valuation Engineers in this case can be proven in this way: Take the whole amount assumed to be paid of $7,849,287.18 to the taxpayer during the assumed forty years. It will necessarily be made up of the assumed forty equal payments of $196,232. It will also equal forty times six per cent on $2,782,551.64 assumed to be paid to the taxpayer as interest on his capital each year in forty different installments assumed to be paid one in each year, plus the remainder of each yearly payment of $196,232 in each year, with interest thereon at four per cent from the year of payment to the end of the forty-year period, respectively, for each year. This last calculation on installments of sinking fund and interest thereon will equal $2,782,551.64. Hoskold's formula with its tables will give the figure for any number of years less than fifty, on a dollar. That figure becomes a multiplier of $7,849,287.18, being the total of all royalty payments if the estimated prophesied tonnage is all extracted, no more and less, if the extractions are equal over forty years, no more and no less, when these requisite fixed assumptions are made.

The question is, what connection has this method of calculating depletion with the statute and with the rule as laid down by this Court? It depends upon assumptions which are notoriously contrary to facts in the record. The assumed total tonnage is something no man can actually know. The basic assumption of equal annual extractions in a fixed amount is contrary to the fact in this case and contrary to all human experience in mining iron ore. In 1917 there were extracted for all the owners' lessors, 6,256,098 tons. In 1918 the extraction was 5,278,570 tons. Of each of these extractions the taxpayer had one-sixth (R. 21). On the assumptions of the formula, one-fortieth of 188,392,892 tons, or 4,709,572 tons, were and must be extracted in each year, and the taxpayer's assumed one-sixth thereof was much less than the actual extraction. But let any reasonable man try to assume such an uneconomical lessee as one who would go at ore extraction in such a wasteful way. The fact is that the depletion unit is calculated on an untrue basis and then applied to an actual extraction. But this depletion unit has nothing to do with the actual market value per ton of the statute.

The radical injustice of such a proceeding is shown by the fact that the unit of depletion is made to depend not on any market value per ton, but on the length of term specified in the lease. One taxpayer gets one depletion and another taxpayer gets another depletion per ton on the very same quality of ore per ton, extracted in the same year at the same place. This is all pointed out by the Circuit Court of Appeals in its opinion (R. 163), although by inadvertence the years are stated in the opinion as 1916 and 1917 instead of 1917 and 1918. If the same sort of calculation is applied to each lease separately, the life of the mine is fixed as the unexpired portion of the lease, so many equal annual extractions are figured to each year of the unexpired term, sinking fund deposits

are calculated in the same way, but the result is that the same taxpayer for the same kind of ore gets under one lease a certain depletion unit per ton and under another lease, another unit.

This was in fact the revised calculation of the Commissioner in this case. Petitioner's brief, p. 38 already referred to shows that the valuation engineers saw the manifest absurdity of calculating on the basis of royalty returns during a number of years long after the leases by their terms would cease to exist. So they treated each lease and depletion thereunder as a separate matter. The brief quotes the agreed statement of facts in the case of McHale v. Hull, which case was decided in 16 Fed. (2d) 781. Mr. Hull was a brother of the respondent here and he was also the owner of a one-sixth interest in these lands and he was suing to recover overpaid assessments for 1917 and 1918. The case was never brought up to this court, and the Government paid the judgment. The petitioner's brief (p. 38) shows that the new calculation was by taking each lease by itself, the unexpired term of a lease was under Hoskold's formula, the years for annual equal extractions. The results were tabulated in an agreed statement of facts which the Government refused to make in this case. Over results of that tabulation the Government counsel draw a charitable veil of silence. The results are as follows:

Lease	Royalty	Estimated Net Receipts of Taxpayer	Life of Mine	Valuation Factor at 6% and 4%	Taxpayers Unit of Depletion	Depl Allo
1	.25	$5,646,798.45	37 years	.374130	.090726	$77,1
2	.25	3,127.40	4 years	.846052	.205128	....
3	.25	197,519.57	39 years	.360832	.087501	1,6
4	.25	386,045.29	30 years	.428283	.105860	2,5
5	.25	48,865.08	34 years	.395772	.095973	1
6	.25	805,757.87	20 years	.534292	.129564	13,1
7	.25	293,556.48	40 years	.354491	.085965	1,4
8	.25	89,555.05	16 years	.590625	.143226	1,1
						$99,1

In the above table the taxpayers unit of depletion is shown for each ton in her one-sixth of the tonnage. In the table as it is given the unit was one-sixth of the amount given above being the taxpayers unit on the whole tonnage extracted.

The inherent and fundamental fault as to law in the Valuation Engineers' calculation adopted by the Commissioner is that they assume a proposition of law contrary to the decisions of this court. It is assumed that the transaction at the time of making the leases, fixed at March 1, 1913, was a sale of all the tonnage in the mine at a figure of twenty-five cents per ton by the lessor to the lessee, but that is not the fact, and the assumption boldly negatives the authoritative decisions. But even then, since the ore is to be paid for in the future without interest, one yearly payment contains less interest than a later yearly payment. Next, the method tries to find, not the element of market value of the ore, but rather what the Commissioner would consider the present value on March 1, 1913, of the lessor's reserved right to receive royalties if extraction takes place uniformly over a fixed period of time, or where extractions in equal yearly quantities in successive years all take place over a hard and fast fixed period of years and the lease continues until the end of the term and all the estimated ore is extracted. The method must assume that the lessee obtained under his leases every ton of ore by full title and sale and an executory contract is thus converted into an executed conveyance. But in this case the extraction never under the leases could extend over the period assumed as the unvarying life of the leases, because, as the opinion of the Circuit Court of Appeals points out (R. 161), the leases would expire before that forty years had elapsed on the first calculation or on the second calculation. And the long leases in *Lynch* v. *Alworth-*

Stephens Co., supra, show the fragility of such an assumption. There the ore was worked out in seven years.

No conversion of the ore resulting in a disposition of it as ore ever takes place until, under the leases, ore is extracted, and then only to the amount of the extraction. Hoskold's formula was never intended to suit such a proposition. The formula was originally devised to furnish some basis for which to guess at the amount to pay outright for a fully exploited mine being sold solely on the basis of the exploited ore. The formula took the estimated tonnage in the mine, which is one conjecture. It said that the buyer can take out that ore and no more or less, and he will take out that conjectured ore in equal yearly amounts. This ore will result in so much money per ton when mined, treated and sold. The formula says, to get at the matter roughly, we can assume equal extractions until the ore is exhausted in so many years. The buyer can afford to pay such a sum as will net him six or more per cent on his investment and also give him enough money each year to put into a sinking fund to reimburse the amount which he is going to pay for the mine. Thus when the ore runs out, the purchaser will have back what he paid and will have made on it in the meantime during his operation of the mine six per cent interest as dividends. The whole proposition is based on a present purchase of the ore where the owner parts with his whole interest and where the owner dictates the extraction. The formula never was intended to be used for a case of lessor of a mine, and if a case of a bargain and sale of an iron mine or of a lease of it, based on such a calculation had ever been made by an owner, he must have been an imbecile. The regulations of the department have now condemned this method. Art. 206, Regulations 69, Art. 226, Regulations 74, says:

"Valuations by analytic appraisal methods, such

as the present value method, are not entitled to great weight. * * * Where the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method."

The Board of Tax Appeals rejected Hoskold's formula in *Owens Bottle Co.* v. *Commissioner,* 8 B. T. A. 1197, 1217. This was a case of depletion of a license agreement under a patent where the Commissioner used Hoskold's formula at 15 per cent for remuneration and four per cent for sinking fund. The depletion by Hoskold's formula was found to be too low and was rejected by the Board. It will be noted that this was a case of no market value where value was required to be reached by some method of analysis other than proof of market value. In a very late case, *U. S.* v. *Garbutt* (C. C. A. 10th Circuit) the Hoskold Present Value Table as a basis for ascertaining market value is pointedly condemned and the regulation condemning it is quoted. We can refer for the case only to United States Daily, November 21, 1929, page 10.

The theory of the Government's counsel is made plain by the question asked by the Government's counsel of defendant's only witness. The question was (R. 37) "In the mining industry, what method is customarily used for depletion, depletion reserves, capital expenditures such as stripping charges, for amortization of bond issues?" This was objected to as wholly irrelevant and immaterial. The court sustained the objection. The Government's counsel observed: "This is a return of the capital account, your Honor, it doesn't make any difference whether it is amortization of bond issues or return of invested capital, that is it." The witness answered: "I say the capital is returned at the same rate as the material is taken out of the ground and in step with that

extraction." Counsel for plaintiff said: "Why, of course, they couldn't pay off anything unless they took something out of the ground; is that what he means?" The Court: "I understand so." Other questions were then asked which submitted to the witness the decision of the case involving the construction of the law and the meaning of its terms and the meaning of the decisions upon it (R. 38). The Government's counsel (R. 39) stated: "I would like to offer to prove by this witness that the custom in the mining industry in regard to setting up depletion reserve and providing for depletion, both in respect to lessor's interest in mines and operating owners and lessees in mines, is to set aside year by year a proportionate part of the March 1, 1913, value of the interest, which proportion is properly—which is the same proportion as is the proportion of the physical body extracted to the total estimated content in a mineral body." But this offer refutes the Hoskold formula of prophecy. According to the effect of the offer, when ore is extracted a reserve is set up out of the receipts of that ore extracted and not in advance of extraction by pure surmise on unwarranted assumptions. The setting up of a reserve based on actual extraction, counsel ought to have seen, refutes the theory of the calculation of the officials. But the whole proposition seems to be one of ignorance. The present Head of the Government says that there is no such practice. H. C. Hoover, Principles of Mining, p. 44.

> "In the practical conduct of mines or mining companies sinking funds for amortization of capital are never established. In the vast majority of mines of the class under discussion, the ultimate duration of life is unknown, and therefore there is no basis upon which to formulate such a definite financial policy, even if it were desired."

The difficulty with the whole conception of the Government is that it is founded on an incorrect legal theory

backed by arbitrary assumptions as to the future which cannot possibly be justified, and which are opposed to the plain common sense of the law and the actual transaction. Yet the engineers had a glimmering of the light, in that they were trying in an illegal way to take care of the interest in deferred payments.

After the Commissioner had arbitrarily put all the leases in under a classification of forty years for the maximum life of each of the leases, a recalculation was made on the basis of each separate lease, giving to each lease its own separate ore reserve assumed to be in the ground leased, assuming as the life of the mine the unexpired portion of the term, and treating each lease as a separate proposition with the same arbitrary assumptions of a fixed annual extraction over a fixed number of years assumed as the life of the mine. The result is shown in the table *supra*. The principle of calculation remains precisely the same. It resulted in a slight reduction in the tax by allowing a varying depletion unit, for the ore extracted under the lease with twenty-five years to run from 1903, of which ten years had expired, leaving sixteen years for the lease to run, showed, of course, a very great depletion unit per ton, because the total of sinking fund payments is total depletion in all the years, and to take care of a sum to pay out twenty-five cents for each ton in sixteen years takes much larger annual sinking fund payments than to pay out the same sum in forty years. That final calculation relied on was not produced but the method is stated in the brief of petitioner, Appendix C, page 38, and it was the method, and we have produced the actual results of the calculations in the table, *supra*. That unit varies from eight cents a ton through nine cents, ten cents, twelve cents, fourteen cents, twenty cents up to twenty-four cents per ton. What becomes of the simple rule of uniformity

prescribed by the statutes? Where under this rule is there any chance to give the lessee his depletion? And what has become of the legal proposition that no title to ore passes except the title to ore actually extracted. The Hoskold method is wrong, because it shows a different unit of depletion for each lease at the same time and place of extraction of the same quality of ore, and necessarily different units for different taxpayers with the same royalty reserved. This result contradicts the statute which puts all taxpayers on the same basis. That fact absolutely refutes the propriety of the calculations of the Valuation Engineers, to say nothing of their violation of the statute.

There is involved in the Government's contention another misconception. In the statute for 1917 the words 'the taxpayer's interest therein" (meaning interest in the property disposed of) are not used, but those words are used in the statute for 1918. The plain commonsense meaning of the taxpayer's interest therein is to say that since ore is the capital asset being converted, the taxpayer's interest therein is the amount of his estate, whether the whole or a part therein. The interest spoken of is an estate in fee in the ore that is the subject of the transaction being accounted for and that ore is the ore extracted during the year or, if the taxpayer has only a life estate, that question must be settled with reference to remaindermen.

The Government says that these words, taxpayer's interest therein, negative the conception of the lease that the thing to be considered is the ore, but rather the taxpayer's interest means what is the calculable value of the lessor in the lease, treating the lease as a present conveyance of all the mines and attempting to arrive at this present value of the lease by conjecture, using the Hoskold formula. The Department does not follow *Lynch* v.

Alworth-Stephens Co., supra, and does not find the lessee's market value in the ore diminished by the lessor's value in the ore, all to be tested by the market value of the ore on March 1, 1913, and market value of the same ore when extracted and when it is ascertained that the ore is extracted and its quantity converted is ascertained, so that there is nothing to deal with but facts. The Government contends that in these leases is an absolute series of promises in each lease to pay a certain amount in each year over a number of years, one promise maturing each year during the whole term of the lease, and these promises are all to be figured by discounting to ascertain what is the present value of each promise, then the present values of each promise on these assumptions are to be added together, and their total shows the present value of the leasehold. This present value is then to be divided by the imagined total tons under the ground, and the result is a depletion of 8.8 cents per ton to be applied to the actually extracted tonnage. This is wholly independent of any market value of ore in the ground and never touches that standard. The theory gets nowhere because the total interest on all the promises is averaged among all the promises, the principle being to charge the taxpayer with interest now, because he expects to get it in the future; *i. e.,* it is a constructive receipt of interest, *tunc pro nunc.*

Suppose as was the case in *Lynch* v. *Alworth-Stephens Company, supra,* the whole body of ore is worked out in seven years, the lessor has been charged in advance with interest earned on the promises as if a large part of them had been outstanding for forty years or thirty, or twenty or ten, as the case may be, earning interest on capital. The scheme cannot work justly, to say nothing of its failure to connect with the law or the nature of the transaction.

The interest of the taxpayer in the leased ore is not an interest in forty promissory notes of equal amounts, one maturing each year after March 1, 1913, but is the fee in one-sixth of the ore, on which fee there is a lease of an undivided one-sixth of each ton of ore in the mine whatever that quantity may be, until extraction, and upon extraction the interest changes into money due as to the ore extracted but does not change as to the rest of the ore left in the ground. The money interest is a one-sixth interest in each ton extracted, measured by the twenty-five cents per ton royalty. This is the same as saying a twenty-five cents interest in one-sixth of the extracted tonnage. The absolute estate of the taxpayer in the ore not extracted has not been at all affected. It is unjust. The lease may be given up or forfeited the next day or the ore may run out in a few years, for economy dictates the taking out of the greatest quantity of ore in a particular place, not mining in different spots over the whole area.

But suppose that the case were one of forty promissory notes payable one each year for forty years. It is plain that in the payment made the first year there is less interest than the one made in the fortieth year. Yet these ingenious engineers lump all the interest together and average it by charging an equal amount of interest in each year. The same observation applies, if the leases are treated separately.

XVI.

THE GOVERNMENTAL REGULATIONS, SO FAR AS THEY ARE APPLICABLE, SUPPORT THE RULE FOR DEPLETION FOLLOWED IN THE LOWER COURT IN THIS CASE.

The regulations in use stated that under paragraphs 7 and 8 of Section 5 there were contemplated two classes

of deduction to take care of the wasting of assets, *i. e.*, (a) depreciation, (b) depletion. Depreciation comprehended loss on improvements other than natural deposits, while the loss of natural deposits was to be considered depletion. And then it was stated in Treasury Decision No. 2446, February 7, 1917, that:

> "In the case of mines • • • if the property was acquired prior to March 1, 1913, the amount of invested capital which may be extinguished through annual depletion deductions from gross income, will be the fair market value of the mine property as of March 1, 1913. The value contemplated herein as the basis for depletion deductions, authorized by this Title must not be based upon the assumed salable value of the output under current operative conditions less cost of production, for the reason that the value under such conditions would comprehend the earning capacity of the property." (This is not very well expressed, but earning capacity of the property means the work of brains and mental effort as well as wages and is the reason why market value of ore in the mine is mentioned in the statute.)

This regulation recognizes at least that mining consists in a liquidation of capital assets and the capital must be returned in depletion, but the only case to which the regulation can be applied is one where the owner of the mine is operating and extracting and selling the ore.

The next paragraph of Treasury Decision No. 2446 is as follows:

> "Neither must the value determined as of March 1, 1913, be speculative, but must be determined upon the basis of the salable value en bloc as of that date, of the entire deposit of minerals contained in the property owned, exclusive of the improvements and development work that is, the price at which the natural deposits of mineral property as an entirety in its then condition, could have been disposed of for cash or its equivalent."

We have quoted above the condemnation of the pres-

ent value method in the regulations, where market value can be arrived at.

This general ban on speculation would certainly forbid the assumptions and speculations necessary under Hoskold's formula. The regulation should have used "market value" instead of "salable value." In law they mean the same thing, but evidently to accountants, salable value means not the same thing as market value. The regulation would require an ascertainment of market value of the ore in the mine as of March 1, 1913. The accountants think the regulation means something other than market value of ore. They think it means averaged value of a series of promissory notes maturing one each year for successive years after the common date of all the notes. The regulation in a loose way conforms to the statute to that extent. It is evidently addressed to a distinction between the market value of the ore and the value of the mine improvements and development work.

These regulations, however, give no warrant to the calculations of the Department in paring down the depletion allowable to suit the Procrustean bed of Hoshold's formula. The Commissioner's epitaph on the present value ascertainment by the Hoskold formula is plain.

XVII.

ANSWER TO PETITIONER'S POINTS.

The first point stated in the brief of the petitioner is that the market value of the ore extracted in the years of accounting for income tax was not proven as of March 1, 1913. What is really meant by that statement is that such value was not proven by the Hoskold formula method.

In the brief of the petitioner the point insisted upon is that in some way the ore remaining in the mine after the year of extraction must be determined. The position is stated on page 8 of the brief of petitioner. "The allowance for depletion should be computed by determining the percentage of the whole reserve which was withdrawn and paid for during the taxable year and taking this same percentage of the value of the taxpayer's interest in the mine on March 1, 1913."

But this precisely what was done in the case. Market value is twenty-five cents per ton or more of all ore in the mine and all ore extracted. The percentage of extraction in tons is to the ore in the mine in tons, whatever it may be, just the same as the market value of the ore extracted is to the market value of the ore in the mine, whatever it may be. There is no need to solve the factually insoluble problem of how much ore there is left in the mine and the statute does not require it.

The next position is (page 19) that the "capital investment should be returned in step with the exhaustion of the physical property," and for this the case of *United States* v. *Ludey*, 274 U. S. 295, is cited. But that is just what the method of the lower court follows.

Next it is said on the same page that "it is necessary to obtain the value on March 1, 1913 of the taxpayer's expected royalties," and on page 8 it is said: "The taxpayer's only interest in the properties on March 1, 1913, was that of lessor, to receive the royalties stipulated in the lease." This position is contrary to all the cases and assumes that the fee owner under the lease has parted with all interest in the unextracted ore. It shows the underlying fallacy of the Hoskold formula method and has been fully answered hereinbefore.

But the fact is that as to ore actually extracted in

any year the allowance for depletion is the value on March 1, 1913, of the promise to pay therefor, for on the method of the lower court, there is taken out of the payment all interest earned on it as a deferred payment from March 1, 1913. It is said (p. 8) that this is what the statutes and regulations require. If so they have been exactly fulfilled. Nothing more than interest has been taken out. Certainly interest for a long term in the future has not been taken out, because it is a fact that payment has been made and the interest thereon has ceased to be paid. The transaction as to ore extracted has been closed and the interest in it is ascertainable as a fact.

Next on page 10 appears a quotation from the record where the witness was asked whether Mrs. Spalding's interest in a ton of ore was twenty-five cents. Of course it was not. It was one-sixth of twenty-five cents. The witness answered in a way that shows that he did not understand the question. He evidently supposed assumptions were necessary. The next witness answered what is evident but said that he was testifying to "the value of a ton of ore regardless of ownership." The next witness did not know what Mrs. Spalding's interest was.

The case of *United States* v. *Ludey*, 274 U. S. at page 302 (page 10 of brief), is misunderstood by counsel. The case there before the court was a case of profit on the sale of a mining property. When a mine is sold, if owned before March 1, 1913, its market value or its value, if it has no market value, at that date must in some way be ascertained. If there be no market value, this ascertainment requires estimating the ore in the mine and to that situation, the language of the court is addressed. The court did not have before it the propriety of any depletion charge, ex-

cept that it stated that from the March 1, 1913, value, the depletion since that date should be deducted from the value on March 1, 1913, as a part of the cost returned, in case of ascertainment of profit on a sale of the property after March 1, 1913, and the deduction should be not the depletion actually taken, but the depletion that ought legally to have been taken. Now in the case of a lease there is no present sale of ore or a mine, and no sale takes place until ore is actually extracted and converted. The Ludey case can have no bearing here, nor was it intended thereby to disapprove *Lynch* v. *Alworth Stephens Co., supra.*

On page 20 of petitioner's brief the testimony of the only witness for the defendant (R. 37-43), now petitioner, is referred to. He said that capital is returned at the same rate as the material is taken out of the ground and in step with that extraction. This seems obvious enough. Next the witness was asked his opinion on the whole law involved (R. 38). An objection was sustained. Next he was asked: "What is the customary method in the mining industry of determining depletion alone?" To this question an objection was sustained. Next the offer to prove was made and this offer was obviated by the witness answering the question as to the general custom in the mining business with reference to determining allowance for depletion (R. 40) and he answered: "We take the value of the mine as of the basic date, and the tonnage in the mine as of that date, we divide the value of the tonnage to get a factor to be used for depletion; then in any one year the number of tons extracted in that year times the factor gives us the amount of depletion." That was precisely what the respondent, then plaintiff, was contending for, and that was precisely what was done.

Then the witness, in answer to questions by the court, "You have to arrive at a figure which represents the tonnage and another figure that represents the value of the mine" answered in the affirmative, and that he did not intend to include in his answer any method as to arriving at the tonnage or as to the value. Then he said that without the value of the owner's interest as of the basic date and without an estimate of the ore reserve, a proper allowance for depletion cannot be determined in accordance with the custom.

Then he answered that certainly under that rule if there were two mines side by side taking out ore of the same quality at the same time the unit of depletion or figure per ton for depletion in one mine might differ very much from the figure or unit of depletion in the other mine by its side (R. 41). Then he answered other questions that showed that he was assuming a certain number of years to extract the ore and was varying the unit of depletion by reference to the amount of ore left in the mine. This was the same old Hoskold formula proposition. Then he finally testified:

> "Q. If the two mines are side by side, and the one takes out exactly the same quantity of ore as the other mine, and the ore is of the same quality, the one mine's depletion is the same as the other mine's depletion, isn't it?
>
> A. It certainly is not. It is the same in amount but not the same in rate. The same number of tons of ore have been taken out, but not the same proportion of the total ore."

The lower court could not possibly find upon this evidence for it did not show how tonnage could be arrived at until total extraction was made nor how market value could be arrived at. This witness was testifying altogether on legal opinions, calling an opinion a legal definition of market value, miscalled a custom.

The case of *New Creek Co.* v. *Lederer,* 295 Fed. 433, was decided on the proposition that the taxpayer could not claim all the market value as depletion, since the plaintiff was a lessor upon royalty reserved. The fact was that there was interest in the royalty payments when made and the court saw that the plaintiff's rule could not be correct.

Next the brief of petitioner at page 21 asserts that "this method disregards the extent of the mineral reserve and permits an allowance which may result in the return of the taxpayer's entire capital prior to the exhaustion of the mine." The method does not require any inquiry as to the extent of the mineral reserve which is not capable of accurate determination. It does not permit, as we have demonstrated heretofore in this brief, a return by depletion of the taxpayer's capital, much less more than that capital. The method does not give a greater capital to a ton of ore mined in one year over a ton of ore mined in a later year. What the method does say is the obvious legal proposition that a ton of ore paid for in 1917 carries less interest on the payment deferred four years from March 1, 1913, than does a ton of ore paid for in 1925 on the payment deferred twelve years from March 1, 1913.

Next it is stated in the brief (p. 21) that there were several mines involved and yet the common rate of depletion was applied to each. But the proof was that the ore was all of the same grade, fifty-four per centum iron and an exceptionally high grade (R. 22, 23). Therefore the unit of depletion per ton, where iron ore has a market value which is the same for all the mines, must be the same for all the mines.

The government here contends for the rule of varying depletion units for the same quality of ore with the same

market at the same time and place, and its contention is based upon a wrong method, and unsound legal propositions. The method has been repudiated by the Commissioner in the regulation which, quoted *supra*, says emphatically, "the present value method" "will not be used if the fair market value can reasonably be determined by any other method." The scheme of trying to amortize capital is said by a high authority, quoted *supra*, as one that is not used in mining. The Hoskold formula method has been thoroughly discredited, as it must be if the statutes are followed, if facts are to govern transactions, if common sense has any part in the income tax administration and if citizens are to stand with equal rights before the law.

Conclusion.

There is a saying of a wise Greek that every matter has two handles, one by which it can be taken hold of and one by which it cannot. It is apparent that the handle of a sale outright of all the ore in the ground under a mining lease at the time of the lease going into effect is a handle by which this problem cannot be grasped, while it is contrary to a series of decisions of this Court.

Congress in enacting the statutes here under consideration laid down an easy rule to follow. This Court has said in *Lynch* v. *Alworth-Stephens Co.*, *supra*, as to this statute:

> "The plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover."

Certainly, when the "curious, narrow, hidden sense" of a statute is one evolved by the ingenuity of expert ac-

countants, who never take into consideration the meaning of legal terms, and who think the law must be wrenched from its legal meaning to fit an inapplicable formula, no court is justified in following them.

We pray the affirmance of the judgment of the Circuit Court of Appeals, with a direction that interest under the statute be allowed to the date of payment of the judgment.

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